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In the Supreme Court of the United States

OCTOBER TERM, 1983

IN THE MATTER OF:

VILLAGE PROPERTIES, LTD.,
A California Partnership,
D/B/A Wolters Village Apartments,

Bankrupt.

WOLTERS VILLAGE, LTD.,

Petitioner,

v.

VILLAGE PROPERTIES, LTD.,

Respondent.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW

(a) Under Section 363 of the Bankruptcy Code of 1978, are proceeds (rents) received during bankruptcy administration for the use of mortgaged property of the Debtor, "cash collateral" for the mortgage debt, to be segregated, administered and used only as provided in Section 363?

(b) Under Section 363 of the Bankruptcy Code of 1978, must a mortgagee make a move of some sort in the bankruptcy proceedings, such as this Court required under the Bankruptcy Act of 1898 in *Butner v. United States*, 440 U.S. 48, 59 L.Ed.2d 136, 99 Sup.Ct. 914 (1979), before rents from mortgaged property can become "cash collateral", or does the "cash collateral" classification of Section 363, by federal law, automatically attach to proceeds from the sale, use or lease of mortgaged property during bankruptcy administration just because of the existence of the mortgage?

(c) Is not oral notice of a mortgagee's claim to rent as "cash collateral" given to the Bankruptcy Judge and Debtor in Possession, in a pre-trial hearing in the Bankruptcy Court, sufficient, under Section 546(b) of the Bankruptcy Code of 1978, to render collaterally assigned rents from mortgaged property "cash collateral" under Section 363 of the Bankruptcy Code of 1978, or is still more required?

PARTIES TO THE PROCEEDINGS

The caption of the case contains the names of all parties, all of which are partnerships.*

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*The partnership partners and assignees thereof are:

Petitioner, Wolters Village, Ltd.: Jordan B. Kirshenbaum, Richardson, Texas; Herman Austern, Warwick, Rhode Island; Melvin L. Becker, Miami, Florida; Helen Donenfeld, Manhasset, New York; Melvin D. Douglas, Miami, Florida; Joseph J. Eisenman, Bayside, Long Island, N.Y.; Norma Flaster, Floral Park, New York; robert Fleishman, Dannville, Pennsylvania; Leonard Granoff, Providence, Rhode Island; Paula Granoff, Providence, Rhode Island; Walter Heimann, Manchester, Connecticut; Irwin Kerber, Dallas, Texas; Sol Koffler, Providence, Rhode Island; Lillian Koffler, Providence, Rhode Island; Robert Leib, Lynbrook, New York; Paul Leib, Lynbrook, New York; Jordan Rice, Pawtucket, Rhode Island; Steven Rice, Pawtucket, Rhode Island; Joseph Robidoux, Pawtucket, Rhode Island; Helen Rosen, Lawrence, Long Island, N.Y.; Alexander Lowy, Jr., Pittsburgh, Pa.; Herman Meltzer, Scarsdale, New York; Jay Meltzer, Scarsdale, New York; Lawrence Meltzer, New York, New York; Shelley D. O'Stop, Collinsville, Conn.; Jack F. Paulson, Valley, Nebraska; Milton Pierce, Warwick, Rhode Island; Bernard Rothschild, Dallas, Texas; H. Alan Frank, Providence, Rhode Island; Walnut Street Dev. Co., McKeesport, Pa.; Al Weinstock, Cranston, Rhode Island; Paul B. Weisz, Providence, Rhode Island; Fred F. Wolf, Warrenton, Virginia; Estelle Wolfson, Lake Worth, Florida; Myrna Kirshenbaum, Richardson, Texas.

Respondent, Village Properties, Ltd.: Southland Capital Properties, Inc., San Diego, California; Conrad A. Will and Marcia M. Will, Trustees, Rancho Sante Fe, California.

TABLE OF CONTENTS

	Page
Questions Presented For Review	i
Parties to the Proceeding	ii
Table of Contents	iii
Table of Authorities	iv
Opinions Below	2
Jurisdiction	2
Statutes Involved	2
Statement of the Case	2
Reasons for Allowance of the Writ	4
Conclusion	7
Certificate of Service	8
Appendix A	A-1
Appendix B	A-3
Appendix C	A-16
Appendix D	A-20

TABLE OF AUTHORITIES

Cases: **Page**

Butner v. United States, 440 U.S. 48, 59 L.Ed.2d 136, 99 Sup. Ct. 914 (1979) . . . . . i, 3

Statutes:

Bankruptcy Act of 1898, As Amended, (11 U.S.C.) (1978) 2, 4, 5

Bankruptcy Code of 1978 (11 U.S.C.) (Pub. Law 95-598, 92 Stat. 2549) 4, 5

Section 362 (11 U.S.C. Section 362) 6

Section 363 (11 U.S.C. Section 363) . . . . i, 2, 3, 4, 5, 6

Section 546(b) (11 U.S.C. Section 546) . . . . . i, 2

28 U.S.C. Section 1254 2

Pub. Law 95-598, Title IV, Section 405, Nov. 6, 1978, 92 Stat. 2686 4

Congressional Reports:

Senate Report 95-989, 2nd Sess., 55 (1978) 5, 6

Texts:

Collier on Bankruptcy (15th Edition), Section 363.04, at pages 363-22 6

IN THE
SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1983

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VILLAGE PROPERTIES, LTD.,
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ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

TO THE HONORABLE WARREN E. BURGER, CHIEF JUSTICE OF THE SUPREME COURT OF THE UNITED STATES AND THE ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES.

By this Petition, Wolters Village, Ltd., as a creditor in bankruptcy proceedings, seeks a writ of certiorari to

review a judgment from the United States Court of Appeals for the Fifth Circuit.

OPINIONS BELOW

The Opinion of the Court of Appeals is reported in 723 Fed.2d 441, and is appended hereto at Page A-3. The Order (Opinion) of the United States District Court is not reported but is appended hereto at Page A-16.

JURISDICTION

The Judgment of the Court of Appeals is dated January 27, 1984, the time of its entry. No motion for rehearing was filed in the Court of Appeals and no order granting an extension of time within which to petition for certiorari has been granted. The statutory provision believed to confer on this Court jurisdiction to review the judgment in question is Section 1254 of Title 28 of the United States Code.

STATUTES INVOLVED

Section 363 of the Bankruptcy Code of 1978, 11 U.S.C. Section 363 (Pub. L. 95-598, 92 Stat. 2549), is set forth at Page A-20 hereof. Section 546(b) of the Bankruptcy Code of 1978, 11 U.S.C. Section 546(b), is set forth in the Opinion of the Court of Appeals, at Page A-15 hereof.

STATEMENT OF THE CASE

In December, 1978, Petitioner sold the Camp Wolters, Texas, housing project to Respondent's predecessor in title, obtaining and retaining a Vendor's Lien, Deed of Trust Lien, and security interest against the assets sold ot secure a no personal liability purchase money note in the amount of

$3,250,000, payable in monthly installments, which, during 1980, were in the amount of $34,746.50 each. The Deed of Trust contained a collateral assignment of rents. In 1979, Respondent became the owner of the property, subject to the 1978 Vendor's Lien, Deed of Trust and Security Agreement. Respondent failed to make the monthly payment on the purchase money note for March, 1980, as well as those that became due thereafter. On May 5, 1980, the Debtor commenced its Chapter 11 proceeding. Following hearings on Respondent's complaint to modify the automatic stay provisions of Section 362 of the Bankruptcy Code of 1978, the Bankruptcy Court permitted the property to be sold at foreclosure on September 2, 1980. The foreclosure left a deficiency on the purchase money obligation of at least $320,000. The gross rents from the Camp Wolters properties collected during the four months of bankruptcy administration of the mortgaged property were about $30,000 per month, or $120,000, more or less. Petitioner, as the Debtor's only creditor, then sought from the Bankruptcy Court all or some of the rents collected by the Debtor in Possession from the mortgaged properties during the four months of their bankruptcy administration on the grounds that such amounts were "cash collateral" for the mortgage note. The Bankruptcy Court ruled that no "cash collateral" under Section 363 of the Bankruptcy Code of 1978 had been created because Petitioner, before foreclosure, had done nothing to enforce its lien against the rents during the bankruptcy administration, such as this Court had required under the Bankruptcy Act of 1898, in *Butner v. United States*, 440 U.S. 48, 59 L.Ed.2d 99 S.Ct. 914 (1979).

In view of the perfection of lien by notice holding by the Court of Appeals (see Pages A-14 and A-15 hereof), it should be noted that during a pre-trial meeting on the Petitioner's Complaint to Modify Stay, in the Summer of 1980,

the Bankruptcy Court and counsel for Debtor were notified of Petitioner's claim to rents as "cash collateral" (Transcript of January 28, 1981 hearing, Page 13). Thus, if notice by a creditor of its claim to "cash collateral" instead of the appointment of a receiver of the mortgaged property already in the legal custody of the Bankruptcy Court will suffice to create "cash collateral", there was "cash collateral" available for Petitioner that the Bankruptcy Judge did not recognize.

The basis of federal jurisdiction of this case in the court of first instance is Pub. L. 95-598, Title IV, Section 405, November 6, 1978, 92 Stat. 2686, dealing with the transition period in bankruptcy matters from 1979 to 1984.

REASONS FOR ALLOWANCE OF THE WRIT

The Court of Appeals has decided important federal bankruptcy questions posed under the Bankruptcy Reform Act of 1978 (Pub. Law 95-598, 92 Stat. 2686), which have not been, but which should be, settled by this Court. The answers are involved in virtually every rehabilitation case under the Bankruptcy Code of 1978. On the answers depends whether the design capabilities of Section 363 are to be drastically curtailed in practice, and the amounts of time and money to be expended in rehabilitation cases in resolving inherent conflicts with mortgagee creditors in the use, lease and sale of mortgaged property.

By the 1960's, in the opinions of many expressed loudly and strongly enough to be plainly heard by Congress, much of the practice under the Bankruptcy Act of 1898, as amended, had become too outmoded, burdensome, contrived, wasteful, inefficient, counterproductive and expensive to be much longer abided.

In considering reform of business enterprise rehabilitation practice under the 1898 Act, as amended, it had to be recognized that successful rehabilitation plans were relatively scarce in relation to the number of proceedings commenced, as few even reached conception before being converted to liquidation cases. In most rehabilitation efforts, early and complete frustration developed fast as reality set in, leaving use and lease of mortgaged property and sale thereof in the ordinary course of business a relatively short-lived subject. Yet, an affordable chance for rehabilitation is needed for those willing to try, there being no standard to identify who should be eligible to try.

Under the 1898 Act, as amended, on the commencement of rehabilitation proceedings, in spite of short average life expectancy, it was incumbent upon secured creditors to race to the courthouse, at enormous expense to both interested parties and the public, to get in line to try to prevent use of mortgaged property or to obtain some *quid pro quo* therefor, in adequate protection hearings conducted while emotions were at their highest, judgments at their poorest, facts the scarcest, and referees the most inundated with problems demanding immediate solutions.

To reform the waste in sale, use and lease of mortgaged property affairs, Congress, in its 1978 Act, devised Section 363, with its "cash collateral" concept, to require affirmative acts of mortgage creditors only if, as and when the expenditure of "cash collateral" is sought by the Trustee or Debtor in Possession to which the mortgagee of the underlying property will not consent, in positive simplification of most of the equations involved in selling, using and leasing mortgaged property during administration.

On the workings of Section 363, *Senate Report 95-989*,

2nd Sess. 55 (1978), advises that rents are "cash collateral", subject to the original lien of the non-cash collateral, and that "cash collateral" is not restricted to property of the estate that is "cash collateral" on the date of the filing of the petition, an idea completely ignored by the Court of Appeals and the Bankruptcy Courts that it cites.

Collier on Bankruptcy (15th Edition), Section 363.04, at page 363-22, also expresses the view that "cash collateral" extends to the proceeds of use, sale and lease of other collateral when it assumes the form of cash, negotiable instruments, cash equivalent, and the like, during the bankruptcy proceedings, citing *Senate Report 95-989*, 2nd Sess. 55, a reference given no significance by the Court of Appeals and the Bankruptcy Courts cited by it.

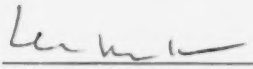
At least in Section 363 matters, the thing the lower courts are missing is that the compulsion for the 1978 reforms and the thrust of those reforms is simple prevention of waste and demand for economy, not just in public costs, but as well the time and effort required of creditors, debtors, and other interested parties. If allowed to serve as stated in the *Senate Report* and in *Collier on Bankruptcy*, Section 363 could be nearly as profound in preventing waste of time and money as were the automatic stay provisions of Section 362 of the Bankruptcy Code of 1978, and the change in the requirement that admitted debt doesn't have to be made the subject of a written claim of each creditor to whom such is owed.

In order for proceeds from the sale, use or lease of mortgaged property used in bankruptcy administration to become "cash collateral" under Section 363, there is need only for a mortgage, or the equivalent, and no need for mortgage creditors to go about getting writs of sequestration

or appointments of receivers of property already in the possession and control of United States courts, and no need to rush to prepare and file other documents in bankruptcy proceedings on hearing of the commencement thereof, and to seek immediate adequate protection hearings and orders.

CONCLUSION

Wherefore, Petitioners pray that a writ of certiorari issue to review the judgment in this case of the United States Court of Appeals for the Fifth Circuit.



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PROOF OF SERVICE

I, Wm. Monroe Kerr, the undersigned counsel for Petitioner, Wolters Village, Ltd., and a member of the Bar of the Supreme Court of the United States, hereby certify that all parties required to be served with copies of the foregoing Petition for Writ of Certiorari have been served, and that I did such on the 23rd day of March, 1984, by serving Village Properties, Ltd., Debtor in Possession and Respondent, by mailing three copies of the Petition for Writ of Certiorari in a duly addressed envelope, with first class postage prepaid, to its attorney of record as follows:

Robert W. Jones, Esquire
3300 Texas Commerce Tower
Houston, Texas 77002-3095

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APPENDIX "A"

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 83-1011

D. C. Docket No. CA 3-81-0463-R

IN THE MATTER OF:
VILLAGE PROPERTIES, LTD.,
a California Partnership,
d/b/a Wolters Village Apartments,

Bankrupt.

WOLTERS VILLAGE, LTD.,

Plaintiff-Appellant,

versus

VILLAGE PROPERTIES, LTD.,

Defendant-Appellee.

Appeal from the United States District Court for the
Northern District of Texas

Before GARZA, WILLIAMS and HIGGINBOTHAM,
Circuit Judges.

JUDGMENT

This cause came on to be heard on the record on appeal and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed;

IT IS FURTHER ORDERED that plaintiff-appellant pay to defendant-appellee, the costs on appeal to be taxed by the Clerk of this Court.

JANUARY 27, 1984

ISSUED AS MANDATE:

APPENDIX "B"

In the Matter of
VILLAGE PROPERTIES, LTD.,
a California Partnership,
d/b/a Wolters Village Apartments,

Bankrupt.

WOLTERS VILLAGE, LTD.,

Plaintiff-Appellant,

versus

VILLAGE PROPERTIES, LTD.,

Defendant-Appellee.

No. 83-1011.

United States Court of Appeals
Fifth Circuit.

Jan. 27, 1984.

A claim in bankruptcy was denied, and the United States District Court for the Northern District of Texas at Dallas, Jerry Buchmeyer, J., affirmed. On further appeal, the Court of Appeals, Garza, Circuit Judge, held that: (1) bankruptcy court must turn to state law to determine whether and at what time a mortgagee has interest in rents, because it is only at that time that it becomes "cash collateral," and same is true notwithstanding enactment of new Bankruptcy Code, which was not intended to preempt state law determination of mortgagee's interest in rents, and (2) where the mortgagee did not petition bankruptcy court for appointment of receiver to collect rents for its

benefit, for order of sequestration or any other order to impound rents, or take any other affirmative action, he failed to perfect his interest under Texas law.

Affirmed.

Appeal from the United States District Court for the Northern District of Texas.

Before GARZA, WILLIAMS and HIGGINBOTHAM, Circuit Judges.

GARZA, Circuit Judge:

I

FACTS and PROCEEDINGS BELOW

Appellant, Wolters, sold the property involved in this dispute to Southland Capital Properties, which sold the property to appellee Village Properties. The second purchase was subject to the original vendor's lien, security agreement and the deed of trust, which included a provision for collateral assignment of rents. Either Village or Southland defaulted on the underlying promissory note and Village filed Chapter 11 bankruptcy on May 5, 1980. On June 5, 1980, appellant filed a complaint to modify the automatic stay to permit foreclosure on his deed of trust on realty and security agreement on equipment.

The bankruptcy court began adjudicating appellant's complaint to modify stay on July 17, 1980. On September 1, 1980, the bankruptcy court ordered foreclosure. On September 2, 1980 the deed of trust, lien and

security agreement securing the payment of Southland Capital's promissory note was foreclosed and appellant acquired possession of the apartment project.

The complaint to modify the stay was the only pleading filed by appellant in this case between the filing of the Chapter 11 petition and the foreclosure sale. Before the foreclosure sale appellant did not petition the bankruptcy court for the appointment of a receiver to collect rents for its benefit, for an order of sequestration or for any other order to impound rents.

Appellant filed a proof of claim against appellee on September 8, 1980, asserting an interest in rents collected between the alleged default and the foreclosure sale. Appellee filed an objection on January 20, 1981, on the ground that appellant was not a creditor of the appellee's estate. After a hearing on stipulated facts, the bankruptcy court entered an order denying appellant's claim on February 11, 1981. Appellant appealed to the district court on February 20, 1981. On December 6, 1982, the district court affirmed the bankruptcy court. Appellant appealed to this court on January 3, 1982.

ISSUE

This case presents one straight forward issue: under the Bankruptcy Code of 1978, does a mortgagee of Texas property who is the holder of a deed of trust that includes a collateral assignment of rents provision, have any secured interest in rents collected by the mortgagor between the time of default on the mortgage and a court ordered foreclosure, where the only action the mortgagee took was filing a complaint to modify the automatic stay and seek foreclosure? Texas law requires a mortgagee to

take affirmative steps to secure his interest in rents collected between default and foreclosure. In *Butner v. United States*, 440 U.S. 48, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979), the Supreme Court held that under the Bankruptcy Act of 1898 state law controls this issue. We hold that *Butner* is still good law under the Bankruptcy Code of 1978. Thus under the Bankruptcy Code we look to state law to determine the issue in this case. We find the lower court interpreted Texas law correctly and we therefore affirm its decision.

Before reaching the main issue in this case we pause to discuss Texas law concerning a mortgagee's interest in rents collected by a bankrupt estate. Texas adheres to the lien theory of mortgages. Under this theory the mortgagee is not the owner of the property and is not entitled to its possession, rentals or profits. Consequently, as occurred in the case at bar, mortgagees usually assign to themselves (through the deed of trust, or other instrument) the mortgagor's interest in all rents falling due after the date of the mortgage as additional security for the mortgage debt. Texas courts have followed the common law rule that an assignment of rentals is not effective "until the mortgagee obtains possession of the property, or impounds the rents, or secures the appointment of a receiver, or takes some other similar action." *Taylor v. Brennan*, 621 S.W.2d 592, 594 (Tex.1981) (citing *Simon v. State Mutual Life Assur. Co.*, 126 S.W.2d 682 (Tex.Civ.App.—Dallas 1939, writ ref'd); *McGeorge v. Henrie*, 94 S.W.2d 761 (Tex.Civ.App.—Texarkana 1936, no writ)).

An absolute assignment of rentals, on the other hand, automatically transfers the right to rentals when a specified condition occurs (e.g. default). An absolute assignment passes title to the rents instead of creating a

security interest. *In Re Ventura-Louise Properties*, 490 F.2d 1141 (9th Cir.1974). Courts have been reluctant to construe assignment of rents as absolute assignments. *Taylor*, 621 S.W.2d at 594. Moreover, some courts and commentators have suggested that there is a presumption that clauses assigning rents create a security interest. *E.g., Childs v. Shelburne Realty Co.*, 23 Cal.2d 263, 268, 143 P.2d 697, 700 (1943); Note, *Assignment of Rents Clauses Under California Law and in Bankruptcy; Strategy for the Secured Creditor*, 31 Hast.L.J. 1433, 1452 (1980).

In *Taylor* the Supreme Court of Texas found that an assignment clause similar to the one in the case at bar manifested an intent by the parties to create a pledge of rentals. 621 S.W.2d at 595. Applying Texas law to the case before us we find that the assignment of rents in the deed of trust only created a security interest. Thus, if state law governs this issue (instead of the Bankruptcy Code) appellant is not entitled to the rents in dispute because it did not take affirmative steps to activate that pledge. For the appellant to prevail in this case Congress must have intended that the Bankruptcy Code preempt state law on the assignment of rents. In addition, the Code must provide that an assignment is automatically activated upon default.

In *Butner* the Supreme Court held that under the Bankruptcy Act of 1898 state law governed a mortgagee's interests in rents and profits earned by property in a bankrupt estate. Appellant notes that the *Butner* decision is limited to the Bankruptcy Act of 1898 and that it specifically recognized that Congress has the authority to enact a federal statute defining a mortgagee's interest in rents. 440 U.S. at 54, 99 S.Ct. at 917.

Although Congress does have such power we find that they did not choose to exercise it pursuant to the Bankruptcy Code. Section 552 of the Code concerns that post-petition effect of a security interest. Section 552(b) provides:

> Except as provided in sections 363, 506(c), 544, 545, 547, and 548 of this title, if the debtor and a secured party enter into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, product, offspring, rents, or profits of such property, then such security interest extends to such proceeds, product, offspring, rents or profits acquired by the estate after the commencement of the case *to the extent provided by such security agreement and by applicable non-bankruptcy law,* except to the extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

11 U.S.C. § 552(b) (1978). (emphasis added). Section 552 is consistent with *Butner.* Its primary design is to permit creditors to take security interests in proceeds pursuant to applicable state law, such as U.C.C. Article 9 or whatever state law applies to security interests in real property. Section 552 reflects Congress' historical concern that property rights usually should be controlled by state law instead of the "mere happenstance" of bankruptcy.

Of course, section 552(b) does permit a bankruptcy judge to deviate from state law "based on the equities of the case." In the case at bar, however, the bankruptcy judge found no equitable reason for not applying the Texas law. Moreover, legislative history regarding the section

indicates its purpose was to cover cases where an expenditure of the estate's funds increases the value of the collateral. H.Rep. No. 595, 95th Cong., 1st Sess. 376-77 (1977), *reprinted in* [1978] *U.S.Code Cong. & Ad.News*, 5787, 6332-33. The House report gives as an example the situation where raw materials are converted into inventory at the expense of the estate (which would thus deplete the fund available for general unsecured creditors). *Id.* at 6333. In the case at bar then, section 552(b) clearly requires application of state law unless appellant can avail itself of the section 363 exception.

Section 363 defines the rights and powers of the trustee regarding the use, sale or lease of estate property and the rights of third parties with interests in the subject property. Section 363 does not create property interests, instead it protects parties with an interest in cash collateral. The section forbids a trustee from using, selling or leasing cash collateral under 363(c)(1) unless each entity with an interest in the cash collateral consents or the court, after notice and a hearing, authorizes such use pursuant to section 363. Noncash collateral can be disposed of in the ordinary course of business even if it is subject to another party's interest. A party can seek "adequate protection" if such property is to be used. § 363(c). Finally, the section requires the trustee to segregate and account for any cash collateral in his possession. § 363(c)(4).

The reference to section 363 in section 552(b) appears on its face to concern the trustee's ability to use, sell and lease secured property. Comments in the Congressional Record are instructive:

> The provision allows the court to consider the equities in each case. In the course of such

> consideration the court may evaluate any expenditures by the estate relating to proceeds and any related improvement in position of the secured party. Although this section grants a secured party a security interest in proceeds, products, offspring, rents, or profits, the section is explicitly subject to other sections of title 11. For example, the trustee or debtor in possession may use or lease proceeds, product, offspring, rents, or profits under section 363.

124 Cong.Rec. H 11,097-98 (daily ed. Sept. 28, 1978); S. 17,414 (daily ed. Oct. 6, 1978), *reprinted in* 4 Collier, Collier on Bankruptcy, ¶ 552.02, at 552-5-6.

Appellant contends that section 363 is broader. Section 363(a) defines cash collateral as "cash... or other cash equivalents in which the estate and an entity other than the estate have an interest, such as a lien or a co-ownership interest." Appellant notes that in describing cash collateral the Senate Report on the Bill on the Bankruptcy Code stated: "[t]o illustrate, rents received from real property before or after the commencement of the case would be cash collateral to the extent that they are subject to a lien." S.Rep. No. 989, 95th Cong., 2nd Sess. 55, *reprinted in* [1978] *U.S.Code Cong. & Ad.News* 5841. Appellant then points out that Congress intended that the definition of "lien" be broad and include inchoate liens. *Id.* at 5811. Appellant also notes that section 101(37) of the Code states that "security interest" means a lien created by an agreement. From this premise appellant reasons that:

> It should be indisputable that a lien under a collateral assignment of rents yet to be collected by the Debtor is an interest in such rents, even though, like most liens, it may need judicial

> enforcement. That it may need judicial enforcement does not make it any less a lien or any less an interest in the rents to be collected. Nothing in § 363 suggests that 'cash collateral', to be 'cash collateral' must already have been judicially enforced. Rather, § 363 provides the mechanism, means and procedure by which the fate of rents collected from and after commencement of bankruptcy proceedings, either for the benefit of the lien holder or for the benefit of the Trustee or Debtor in Possession, or both, as the facts unfolded.... The fact that the interest under state law is not self enforcing, does not make the collateral assignment any less a lien, or the lien any less an interest, on as yet uncollected rents.

Appellant's brief, at 18-19.

Appellee points out that section 363 defines cash collateral as "cash ... in which the estate and an entity other than the estate *have an interest.*" Appellee argues that bankruptcy courts must turn to state law to determine whether and at what time a mortgagee has an interest in the rents because it is only at that time that it becomes "cash collateral."

We agree with appellee. Whether or not appellant's lien is "any less a lien," under Texas law it is impotent with regard to rents until it is perfected. We reject appellant's unsubstantiated reasoning that Congress intended for section 363 to preempt state law which traditionally determines the property rights at dispute in this case. "[S]tate-created property rights, in a bankruptcy context, will not be destroyed by implication." *In the Matter of Jeffers*, 3 B.R. 49, 56 (Bkrtcy.N.O.Ind.1980) (citing *Butner*). Moreover, the comment in Senate Report 989, on which

appellant relies, provides that rents received "before or after the commencement of the case would be cash collateral *to the extent* that they are subject to a lien." This language mirrors the provision in section 552(b), which provides that a security interest will exist "to the extent provided by such security agreement and by applicable nonbankruptcy law ..." Thus if appellant's claim fails under section 552(b), 363 is to no avail.

We hold that the *Butner* decision remains unscathed by the new Bankruptcy Code. Courts addressing this issue, two dealing specifically with rent assignments, have noted its continuing validity. *E.g., In Re Jenkins,* 13 B.R. 721, 723 (Bkrtcy.D.Col.1981); *rev'd on other grnds* 19 B.R. 105, 107 (D.C.Col.1982); *In Re Oak Glen R-Vee,* 8 B.R. 213, 216 n. 3 (Bkrtcy.C.D.Cal.1981); *In Re Gaslight Village, Inc.,* 6 B.R. 871, 874 (Bkrtcy.D.Conn.1980); *In Re Hellenschmidt,* 5 B.R. 758, 760 (Bkrtcy.Ct.D.Col.1980); *In Re Wheeler,* 5 B.R. 600, 603 (Bkrtcy.N.D.Ga.1980); *In the Matter of Jeffers,* 3 B.R. 49, 56 (Bkrtcy.N.D.Ind.1980), *see, e.g., In Re Kuhn Construction Co., Inc.,* 11 B.R. 746 (Bkrtcy.S.D. W.Va.1981). An examination of the legislative history reveals that Congress did not intend for the Code to preempt state law determination of a mortgagee's interests in rents. This conclusion comports with "the principle of bankruptcy jurisprudence ... that federal law supercedes state law only to the extent necessary to further federal objectives." *In Re Hellenschmidt,* 5 B.R. 758, 760 (Bkrtcy.D.Col.1980). The policy considerations and federalism concerns that underpin the *Butner* decision are just as applicable to the new code as they were to the 1898 Act. As the Supreme Court has noted: "uniform treatment of property interests by both state and federal courts within a state serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving 'a windfall

merely by reason of the happenstance of bankruptcy." *Butner* 440 U.S., at 55, 99 S.Ct., at 918 (quoting *Lewis v. Manufacturers National Bank*, 364 U.S. 603, 609, 81 S.Ct. 347, 350, 5 L.Ed.2d 323 (1961)).

Thus we apply state law to determine appellant's interest in the collateral rents involved in this case. As noted, the appellant did not even attempt to obtain sequestration or take other affirmative action. He therefore has not perfected his interest. In future cases, however, federal courts may be faced with situations where a Texas mortgagee petitions for sequestration, a receiver or adequate protection but the granting of the petition is delayed or denied. We recognize that judicial enforcement of collaterally assigned rents seldom occurs in Texas.[1] Under the Bankruptcy Code, however, such petitions need not be granted by a federal court for the Texas mortgagee to perfect his interest in rentals. It should be remembered that in *Taylor* the Texas Supreme Court held that an assignment of rentals becomes operative when the mortgagee "obtains possession of the property, or impounds the rents, or secures the appointment of a receiver, *or takes some other similar action.*" 621 S.W.2d at 594 (emphasis added). The filing of such a petition requires affirmative action which is equivalent to the spirit of the *Taylor v. Brennan* requirements. The form of the action required to perfect the mortgagee's interest is not as important as its substantive thrust—diligent action by the mortgagee which demonstrates that he would probably have obtained the rents had bankruptcy not intervened.

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[1] Texas utilizes a fast method of foreclosing deeds of trust, and without leaving equities of redemption behind through private trustees appointed for that purpose. The process only entails written notice to the owner and public notice posted on the courthouse door for twenty-one days prior to the date of sale, the first Tuesday of each calendar month. Consequently, judicial foreclosure is seldom necessary and judicially enforced collection of collaterally assigned rents is rare.

Giving undue weight to the procedural form of the affirmative action required by Texas law would handicap a mortgagee under the Bankruptcy Code. For example, section 105(b) of the Code prohibits appointment of a receiver. Moreover, obtaining "adequate protection" under section 363(e) is conditioned upon one having an "interest" in the property. Obviously, if a mortgage does not have such an interest under Texas law he cannot obtain "adequate protection." The logical solution is to perfect the Texas mortgagee's interest when he petitions for sequestration, a receiver, adequate protection, etc. Although some states hold that perfection should occur only upon actual possession[2] we believe that the "or takes some other similar action" language in *Taylor* encompasses perfection of a mortgagee's interest by petitioning for sequestration and the like. In a recent case, involving California law very similar to Texas, a court held that filing an action to require the debtor to cease spending, to segregate, and to account for all rents, income etc. perfected the mortgagee's interest from the date of the filing. Although the court denied sequestration because of a $1 million dollar equity cushion, it noted that the mortgagee deserved perfection because he would have obtained the rents under California law if bankruptcy proceedings had not intervened. *In Re Oak Glen R-Vee*, 8 B.R. 213, 216 (Bkrtcy.C.D.Cal.1981); *see also Groves v. Fresno Guarantee Savings & Loan Ass'n*, 373 F.2d 440, 442-43 (9th Cir.1967); *Pollack v. Sampsell*, 174 F.2d 415, 418-19 (9th Cir. 1949).

We also note that Congress has recognized the wisdom of allowing a security interest in rents to be perfected through mere notice. Section 546(b) provides that:

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[2] *In the Matter of Michigan Ave. National Bank*, 2 B.R. 171, 185 (Bkrtcy.N.D.Ill.1980)

> The rights and powers of the trustee under section 544, 545, or 549 of this title are subject to any generally applicable law that permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of such perfection. If such law requires seizure of such property or commencement of an action to accomplish such perfection, and such property has not been seized or such action has not been commenced before the date of filing of the petition, such interest in such property shall be perfected by notice within the time fixed by such law for such seizure or commencement.

11 U.S.C. § 546(b) (Supp. II 1978).

For the foregoing reasons the decision of the lower court is AFFIRMED.

APPENDIX "C"

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

CA 3-81-0463-R

WOLTERS VILLAGE, LTD.,

Appellant,

VS.

VILLAGE PROPERTIES, LTD.,

Appellee.

Filed Dec. 6, 1982

ORDER

1. This is an appeal from an order entered by the Bankruptcy Court after a hearing on January 28, 1981. The facts were undisputed. The basic issue was whether or not the decision in *Butner v. United States*, 440 U.S. 48 (1979)—that state law controls the validity and scope of security interests in bankruptcy proceedings—is still valid under the new Bankruptcy Code. The Bankruptcy Court correctly determined that *Butner* is still controlling and, accordingly, his order is affirmed.

2. Appellant Wolters Village held a deed of trust for an apartment project which was the sole substantial asset of the appellee Village Properties. On June 5, 1980, the appellant filed a Complaint to Modify the Stay of the Chapter XI bankruptcy proceedings filed by appellee on May 5,

1980. The stay was lifted on September 1, 1980 to permit appellants foreclosure on the property; the foreclosure sale was held on September 2, 1980. Subsequently, on September 8, 1980, the appellant filed a deficiency claim for the amount of rentals ($150,000) which had been collected by the appellee as debtor in possession, from the date of the Chapter XI proceeding to the foreclosure (approximately May 5—September 1, 1980).

3. The Complaint to Modify Stay was the only pleading filed by appellant in the Chapter XI proceeding before the foreclosure sale. At no time before then did appellee (i) petition the Bankruptcy Court for appointment of a receiver to collect rents for the benefit of appellant, (ii) petition the Bankruptcy Court for an order of sequestration, or (iii) petition the Bankruptcy Court for an order impounding rents collected by the appellee. At no time did appellant allege a "lack of adequate protection" with regard to the rents. Subsequent to the foreclosure, the deficiency claim for the rental was filed.

4. The Bankruptcy Court specifically ruled that appellant Wolters Village was not a creditor of the estate of appellee Village Properties. Specifically, the Bankruptcy Court ruled:

> (i) Under Texas law, a mortgagee is not entitled to rents and revenues generated by a mortgage property until possession of the property is taken from the mortgagor, even when a deed of trust provides for an assignment of rents (as the deed of trust did in this case).
>
> (ii) Under *Butner v. United States*, 440 U.S. 48 (1979), this principle of Texas law still applies in

the context of a bankruptcy under the new Bankruptcy Code; and

(iii) In order for appellant to preserve any right to the rentals, it should have petitioned the court for appointment of a receiver or sequestration or it should have sought "adequate protection" pursuant to § 363 of the Bankruptcy Code.

This decision reached by the Bankruptcy Court is correct.

5. Under Texas law, until possession of mortgage property is taken from the mortgagor, the mortgagee is not entitled to the rents and revenues generated by the property—even if there is an assignment of rentals in the mortgage. *McGeorge v. Henrie*, 94 S.W.2d 761 (Tex.Civ.App.—Texarkana 1936); *Johnston v. Lasker Real Estate Assoc.*, 21 S.W. 961 (Tex.Civ.App. 1893).

6. Under *Butner v. United States*, state law determines the scope of security interests in bankruptcy proceedings—specifically, in that case, the state law determined who was entitled to rents collected on mortgage property between the date of the mortgagor's bankruptcy petition and the foreclosure sale of the mortgaged property. See 440 U.S. at 54-56.

7. The decision in *Butner* has not been changed by the new Bankruptcy Code. Therefore, the Bankruptcy Court was correct in following *Butner* in this matter:

(i) *Butner* has been considered in several cases under the new Bankruptcy Code, including two dealing specifically with assignments of rents, and the discussion in each of these has confirmed that *Butner* is still applicable. See *In Re Kuhn*

Construction Co., Inc., 11 B.R. 746 (U.S. Bankruptcy Court S.D. W.Va. 1981); *In Re Gaslight Village, Inc.*, 6 B.R. 871 (U.S. Bankruptcy Court D. Conn. 1980); *In Re Oak Glen R-Vee*, 8 B.R. 213, 216 (U.S. Bankruptcy Court C.D. Cal. 1981). See also *In Re Hellenschmidt*, 5 B.R. 758 (U.S. Bankruptcy Court V. Cal. 1980); *In Re Wheeler*, 5 B.R. 600, 603 (U.S. Bankruptcy Court N.D. Ga. 1980); comment "Assignment of Rents Clauses Under California Law and in Bankruptcy: Strategy for the Secured Creditor," 31 Hastings L.J. 1433 (July 1980).

(ii) Section 552 of the new Bankruptcy Code does, contrary to the appellants argument, codify the deference of Congress to state law in the area of the affect of security interests. See the Hastings Law Journal comment cited in the preceding paragraph; see also *In Re Kuhn Construction Co., supra.*

8. In addition, the Bankruptcy Court correctly concluded that § 303, the "cash collateral" provision, does not change the result in this matter. Under § 363, the Bankruptcy Court must still refer to state law in applying that provision. See *In Re Kuhn Construction Co., supra;* and see the Hastings Law Journal comment cited above. Moreover, at no time did appellant Wolters Village seek any "adequate protection" under § 363—i.e., appellant did not request any relief concerning the rentals being collected, such as sequestration, appointment of a receiver for collection of rents, or any other relief.

9. For these reasons, the order of the Bankruptcy Court is affirmed.

SIGNED this 6th day of December, 1982.

/S/ JERRY BUCHMEYER
UNITED STATES DISTRICT JUDGE
JERRY BUCHMEYER

APPENDIX "D"

SECTION 363 (11 U.S.C. § 363)

§ 363. Use, sale, or lease of property.

(a) In this section, "cash collateral" means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents in which the estate and an entity other than the estate have an interest.

(b) The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.

(c) (1) If the business of the debtor is authorized to be operated under section 721, 1108, or 1304 of this title and unless the court orders otherwise, the trustee may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing.

(2) The trustee may not use, sell, or lease cash collateral under paragraph (1) of this subsection unless—

(A) each entity that has an interest in such cash collateral consents; or

(B) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with the provisions of this section.

(3) Any hearing under paragraph (2) (B) of

this subsection may be a preliminary hearing or may be consolidated with a hearing under subsection (c) of this section, but shall be scheduled in accordance with the needs of the debtor. If the hearing under paragraph (2) (B) of this subsection is a preliminary hearing, the court may authorize such use, sale, or lease only if there is a reasonable likelihood that the trustee will prevail at the final hearing under subsection (e) of this section. The Court shall act promptly on any request for authorization under paragraph (2) (B) of this subsection.

(4) Except as provided in paragraph (2) of this subsection, the trustee shall segregate and account for any cash collateral in the trustee's possession, custody, or control.

(d) The trustee may use, sell, or lease property under subsection (b) or (c) of this section only to the extent not inconsistent with any relief granted under section 362(c), 362(d), 362(e), or 362(f) of this title.

(e) Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest. In any hearing under this section, the trustee has the burden of proof on the issue of adequate protection.

(f) The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if—

(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;

(2) such entity consents;

(3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of such interest;

(4) such interest is in bona fide dispute; or

(5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

(g) Notwithstanding subsection (f) of this section, the trustee may sell property under subsection (b) or (c) of this section free and clear of any vested or contingent right in the nature of dower or curtesy.

(h) Notwithstanding subsection (f) of this section, the trustee may sell both the estate's interest, under subsection (b) or (c) of this section, and the interest of any co-owner in property in which the debtor had, immediately before the commencement of the case, an undivided interest as a tenant in common, joint tenant, or tenant by the entirety, only if—

(1) partition in kind of such property among the estate and such co-owners is impracticable;

(2) sale of the estate's undivided interest in such property would realize significantly less for the estate than sale of such property free of the interests of such co-owners;

(3) the benefit to the estate of a sale of such property free of the interests of co-owners outweighs the detriment, if any, to such co-owners; and

(4) such property is not used in the production, transmission, or distribution, for sale, of electric energy or of natural or synthetic gas for heat, light, or power.

(i) Before the consummation of a sale of property to which subsection (g) or (h) of this section applies, or of property of the estate that was community property of the debtor and the debtor's spouse immediately before the commencement of the case, the debtor's spouse, or a co-owner of such property, as the case may be, may purchase such property at the price at which such sale is to be consummated.

(j) After a sale of property to which subsection (g) or (h) of this section applies, the trustee shall distribute to the debtor's spouse or the co-owners of such property, as the case may be, and to the estate, the proceeds of such sale, less the costs and expenses, not including any compensation of the trustee, of such sale, according to the interests of such spouse or co-owners, and of the estate.

(k) At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.

(l) The trustee may use, sell, or lease property under subsection (b) or (c) of this section, or a plan under chapter 11 or 13 of this title may provide

for the use, sale, or lease of property, notwithstanding any provision in a contract, a lease, or applicable law that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title concerning the debtor, or on the appointment of a taking* possession, by a trustee in a case under this title or a custodian, and that effects, or gives an option to effect, a forfeiture, modification, or termination of the debtor's interests in such property.

(m) The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.

(n) The trustee may void a sale under this section if the sale price was controlled by an agreement among potential bidders at such sale, or may recover from a party to such agreement any amount by which the value of the property sold exceeds the price at which such sale was consummated, and may recover any costs, attorneys' fees, or expenses incurred in voiding such sale or recovering such amount. The court may grant judgment in favor of the estate and against any such party that entered into such agreement in willful disregard of this subsection for punitive damages in addition to any recovery under the preceding sentence.

* As enacted